

**DEPARTMENT OF STATE REVENUE**

**LETTERS OF FINDINGS NUMBERS: 00-0214  
00-0215**

**ADJUSTED GROSS INCOME TAX  
For Years 1996 & 1997**

NOTICE: Under Indiana Code § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Adjusted Gross Income Tax – Add Back of State Income Taxes.**

<b><u>Authority:</u></b>	<b>IC § 6-2.1-1-2(a)(1)</b>	<b>IC § 6-3-1-3.5</b>
	<b>IC § 6-2.1-2-1</b>	<b>IC § 6-3-2-2</b>
	<b>IC § 6-2.1-2-2</b>	<b>45 IAC 3.1-1-8</b>

Taxpayers, through parent corporation, protest the addback of state income taxes.

**II. Tax Administration - Penalty**

<b><u>Authority:</u></b>	<b>IC § 6-8.1-10-2.1</b>	<b>45 IAC 15-11-2.1</b>
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Taxpayers, through parent corporation, protest the imposition of the 10% negligence penalty.

**STATEMENT OF FACTS**

Taxpayers are Indiana corporations, part of a nation-wide chain of restaurants. Taxpayers' parent corporation (not an Indiana taxpayer), files consolidated federal tax returns for all the individual restaurants, paying all state and federal taxes. The parent charges the tax back to each restaurant who then reimburses the parent through the payment of management and other administrative fees the parent charges as administrative costs.

The Department audited taxpayers for tax years 1996 and 1997. The Department assessed adjusted gross income tax for taxpayers' failure to add back the proper amount of taxes deducted on the federal return, and imposed the 10% negligence penalty. Taxpayers, through the parent, timely protested and a hearing was scheduled.

After the notice of hearing was issued and before the hearing was held, the parent, at the Department's request, sent in several sets of documents showing how the management fees were broken down, and how the federal returns for the two non-compliant restaurants were filled out. Based on the documents taxpayer sent, and a series of telephone conversations between the Hearing Officer and the parent, the Department and the parent concluded all information necessary to resolve taxpayers' protests had been produced. Therefore, this Letter of Findings is based on information contained in the files, taxpayer's additional documentation, and a series of telephone conversations. Further information will be provided as necessary.

**I. Adjusted Gross Income Tax: Add-Back of State Income Taxes.**

**DISCUSSION**

The taxpayers, through the parent corporation, protest the add-back of state income taxes to their Indiana state income tax liability, taxes that were allegedly deducted in error on the consolidated federal returns by the parent corporation. The State of Indiana requires that all state income taxes based on income be added back to arrive at the state modified adjusted gross income tax for taxable income. See, IC § 6-3-1-3.5(b)(3). Taxpayers did not include the taxes paid to Indiana as an add-back.

Taxpayers, one located in Indianapolis and one in Evansville, are part of a nation-wide chain of restaurants. Both are incorporated in Indiana, but neither files a consolidated Indiana tax return with the parent. The parent pays the income, property, withholding, sales, and food and beverage taxes for all the subsidiaries (including taxpayers). The parent, to obtain discounts from vendors, makes bulk purchases of food sold by the restaurants. The parent also makes many of the operating decisions for the subsidiaries, including accounting functions. The subs are then charged management fees that cover the parent's costs.

The taxpayers deducted, through the parent, state income taxes on the consolidated federal income tax return. The parent files a consolidated federal tax return for all the subsidiaries and deducts the state income taxes on the federal 1120 form. However, when the two taxpayers' Indiana state income tax returns were prepared, the state income taxes paid were not shown as a deduction, nor were they added back to the adjusted gross income tax as required by Indiana's tax statutes and regulations. The parent claimed the deduction. The parent corporation did not include the state income taxes as an add-back to the adjusted gross income tax on the taxpayers' Indiana tax returns as required by Indiana's tax statutes and regulations. All taxes are shown on the parent's return, but none at the state level for the two taxpayers at issue.

The tax liability at issue belongs to the taxpayers; it is their responsibility and was therefore actually deductible by them. As all the restaurants file a consolidated federal income tax return, the issue of where the tax was deducted has no tax effect for federal purposes. The tax was in fact deducted on the federal return of the consolidated group. Either the parent erred in showing the tax as being deductible by the parent, or the parent was in fact reimbursed by the individual restaurants for the tax paid on their behalf through management fees or other intercompany

transfers/eliminations. Regardless, the Department is correct in requiring taxpayers to add back the state income taxes deducted.

The taxpayers, through the parent's Letter of Protest, questioned the add-back of the management fees they paid to the parent, arguing that an error had been made in filling out the consolidated federal tax returns:

The State of Indiana asserts that the taxpayers did not add back to taxable income, the State income taxes paid to the State of Indiana. The State correctly recognizes that the taxes were not "shown as a deduction" in the tax return but incorrectly suggests that the State income tax deductions are included in the management fees and that part of the deducted management fees paid to the to the [sic] Parent Corporation are "in lieu of the actual state income taxes."

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In order to maintain some control over the State Income Tax payment process, the Parent Corporation also pays all of the State Income Taxes for the benefit of the taxpayers. On an estimated basis the taxpayers are charged for their share of the Federal Income Tax liability and for the estimated state income taxes.

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Attached as Schedule 1 to this protest is a copy of page 4 of the taxpayer's Federal Income Tax Returns. As you will note in Schedule M-1 on line 2 there is an amount that is added back to the book income and accordingly not deducted at arriving at taxable income. While the notation in the return indicates that these amounts are "Federal income tax," in fact this notation is incorrect. The numbers represent the taxpayer's estimated share of both Federal and State of Indiana income taxes and the total charge that they incurred for income taxes.

Pursuant to IC § 6-3-1-3.5(b)(3), taxpayers should have added back the amount of Indiana income tax the parent deducted on the consolidated federal tax return and then collected through management fees charged to the taxpayers:

When used in IC 6-3, the term "adjusted gross income shall mean the following:

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

(3) Add an amount equal to any deduction or deductions allowed or **allowable** pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States. (emphasis added)

Further, 45 IAC 3.1-1-8 provides:

Definition of adjusted gross income for corporations.

“Adjusted Gross Income” with respect to corporate taxpayers is “taxable income as defined in Internal Revenue Code section 63 with three adjustments:

(3) Add back deductions taken pursuant to Internal Revenue Code section 63 for:

**(a) Taxes based on or measured by income and levied at the state level. For purposes of this subsection, the Indiana Gross Income Tax is a state tax measured by income and must be added back. (emphasis added)**

Taxpayers’ adjusted gross income tax deficiencies fall precisely within the ambit of the cited statutory and regulatory language. Audit initially based the amount of tax to be added back on the amount of estimated tax payments made by corporate headquarters on behalf of its subsidiaries (i.e., the restaurants). The amount of tax to be added back, however, should have been based on the subsidiaries’ proportionate share of the consolidated federal deduction of state income tax.

### **FINDING**

The taxpayers’ protests concerning the add-back of taxes are denied. A supplemental audit should be completed to make the necessary corrections.

## **II. Tax Administration – Penalty**

Taxpayers protest the Department’s imposition of the 10% negligence penalty. Indiana Administrative Code, Title 45, Article 15, Rule 11-2(b) provides in pertinent part:

“Negligence” on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer’s carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence.

Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

In determining whether or not to assess the 10% penalty, the Department looks for indicia of negligence as well as indicia of due diligence. The taxpayers, through the parent, were negligent because the parent failed to read and follow instructions on the Indiana tax returns. It does not

matter that the returns are “pro forma.” If taxpayers, through the parent, are going to rely on “pro forma” returns in fulfilling their statutory duties under Indiana’s tax code and regulations, then the Department is fully justified in relying on “pro forma” returns in assessing tax deficiencies.

**FINDING**

The taxpayer’s protest is denied.